Regulatory and Other Measures

June 2011

RBI/2010-11/552 Ref: DBOD. No.Ret. BC. 97/12.06.128/2010-11 dated June 1, 2011

Inclusion in the Second Schedule to the Reserve Bank of India Act, 1934 – Credit Suisse A.G

All Scheduled Commercial Banks

We advise that the name of 'Credit Suisse A.G' has been included in the Second Schedule to the Reserve Bank of India Act, 1934 by notification DBOD IBD. No. 13983/23.03.025/2010-11 dated March 8, 2011, published in the Gazette of India (Part III – Section 4) dated April 2, 2011.

RBI/2010-11/553 Ref: DBOD. No.Ret. BC. 98/12.06.129/2010-11 dated June 1, 2011

Inclusion in the Second Schedule to the Reserve Bank of India Act, 1934 – Sberbank

All Scheduled Commercial Banks

We advise that the name of '**Sberbank**' has been included in the Second Schedule to the Reserve Bank of India Act, 1934 by notification DBOD IBD. No. 13982/23.03.022/2010-11 dated March 08, 2011, published in the Gazette of India (Part III – Section 4) dated April 2, 2011.

RBI/2010-11/554 DBS.CO.FrMC.BC.No. 9/23.04.001/2010-11 dated May 26, 2011

Internal Vigilance in Private Sector/Foreign Banks

Chairmen/Chief Executive Officers
All Private Sector Banks/Foreign Banks

As you are aware the Central Vigilance Commission has issued guidelines to Public Sector Banks on the appointment of Chief Vigilance Officer in all public sector Banks. The purpose of this is to ensure that all the internal vigilance functions in the public sector banks are addressed through a set of predetermined and structured procedures to ensure comprehensive treatment and transparency.

2. RBI has also issued various circulars for the prevention of frauds and malpractices in banks. In this connection reference is specifically drawn to circulars DBOD. No.BC.20.17.04.001 dated August 25, 1992 on the recommendation of the Committee to enquire into various aspects relating to frauds and malpractices in bank; DOS.No.PP.BC.20/16.03.026/96-97 dated November 01, 1996 conveying the recommendations of the Working group on Internal Controls and Inspection/Audit Systems in banks; DBS.FrMc.No.7/23.04.001/2004-05 dated September 20, 2004 on strengthening of Internal Vigilance machinery in banks & Financial Institutions.

3. In an endeavour to align the vigilance function in Private sector and Foreign Banks to that of the Public Sector Banks the existing vigilance functions of a few private sector and foreign banks were mapped with the existing guidelines in the matter and it was observed that the practices vary widely among the banks. It has, therefore, been decided to lay down detailed guidelines for private sector and foreign banks on similar lines so that all issues arising out of lapses in the functioning of the private sector and foreign banks especially relating to corruption, malpractices, frauds *etc*, can be addressed uniformly by the banks for timely and appropriate action.

4. The detailed guidelines placed at the annex are aimed towards bringing about uniformity and rationalisation in the function of internal vigilance. You are advised to put in place a system of internal vigilance machinery as per the guidelines within a period of three months from the date of this circular with the approval of your Board. A compliance report to this effect may be submitted to RBI on or before August 31, 2011.

RBI/2010-11/555 DBS. CO.FrMC.BC.No. 10/23.04.001/ 2010-11 dated May 31, 2011

Findings of Forensic Scrutiny- Guidelines for prevention of frauds

The Chairmen & Chief Executive Officers of
All Scheduled Commercial Banks (excluding RRBs) and
All India Select Financial Institutions

In the recent past, we had conducted forensic scrutinies at certain identified banks due to occurrence of large value frauds or sharp increase in number of frauds at such banks. The scrutinies were undertaken to primarily identify the policy gaps, if any, and adequacy of controls. During the scrutinies, systemic factors were also sought to be identified.

2. Based on the findings of the scrutinies, further study has been made across banks to ascertain the policy and operating framework in place for detection, reporting and monitoring of frauds as also the surveillance/oversight process in operation so as to prevent the perpetration of frauds. The study has shown that while the banks do have certain policies and processes in this regard, they are not well structured and systematic to ensure proper focus on typical fraud events. Besides, there is lack of consistency in treatment of such transactions having characteristics of fraud as also in their reporting to the 'Competent Authority'. The banks are, therefore, advised to suitably modify their policy and streamline the operating framework in the matter keeping in view certain indicative guidelines set out below :

3. The reported frauds show recurrence or rising trend in the following areas:

- loans/advances against hypothecation of stocks
- housing loans cases
- submission of forged documents including letters of credit
- escalation of overall cost of the property to obtain higher loan amount
- over valuation of mortgaged properties at the time of sanction
- grant of loans against forged FDRs
- over-invoicing of export bills resulting in concessional bank finance, exemptions from various duties *etc.*
- frauds stemming from housekeeping deficiencies

The above list is only illustrative and not exhaustive.

The banks need to introduce closer monitoring and tighter controls in the above areas, as also in other such areas where there is typically certain degree of concentration of occurrence. In this connection, select list of circulars issued by RBI in the past in respect of frauds in the above areas.

4. The operating framework for tracking frauds and dealing with them should be structured along the following three tracks:

(i) Detection and reporting of frauds

(ii) Corrective action and

(iii) Preventive and punitive action

Detection and reporting: The banks should have a set of prescribed procedures and criteria with which the events or transactions having serious irregularities are analysed and assessed to establish occurrence of fraud.

For this purpose, the banks may define a 'fraud' based on the guidelines issued by RBI. While doing so, they may clearly demarcate/distinguish the occurrence of an event on account of negligence 'in conduct of duty' from 'collusion' by the bank staff (with the borrowers and with an intention to cheat the bank). Further, care may be exercised while dealing with instances of 'willful default'. In this connection, a willful default would be deemed to have occurred if any of the following events is noted:

(a) The unit has defaulted in meeting its payment/ repayment obligations to the lender even when it has the capacity to honour the said obligations.

(b) The unit has defaulted in meeting its payment/ repayment obligations tothe lender and has not utilised the finance from the lender for the specific purposes for which finance was availed of but has diverted the funds for other purposes.

(c) The unit has defaulted in meeting its payment/repayment obligations to the lender and has siphoned off the funds so that the funds have not been utilised for the specific purpose for which finance was availed of, nor are the funds available with the unit in the form of other assets.

(d) The unit has defaulted in meeting its payment/repayment obligations to the lender and has also disposed off or removed the movable fixed assets or immovable property given by him or it for the purpose of securing a term loan without the knowledge of the bank/lender.

Further, the banks may also examine the '*intent*' to defraud, irrespective of whether or not actual loss takes place. Keeping these key factors in mind, any action taken in collusion to derive undue/unjust benefit or advantage should be termed as fraud.

Following such a protocol of identification, once a fraud is detected, a report must be prepared and submitted to the 'Competent Authority'. As a part of their overall policy and operating framework, the banks should identify and designate the Competent Authority to whom such reports should be submitted. The fraud report should be a diagnostic assessment, clearly bringing out the causes of the fraud and identify whether the fraud occurred due to 'system failure' or 'human failure'.

Corrective Action: An important corrective step in a fraud is recovery of the amount siphoned off through the fraud. Often, during course of investigation and enquiry into the events/transactions, the need to track the flow of defrauded amount does not get due priority or the exercise undertaken in that direction does not lead to material results. This may be primarily attributable to the following:

- The lack of ability on the part of the operating staff to sift through the layered/interlocked transactions, determine the ultimate destination of the defrauded amounts and track the investment of the amounts in assets/properties and/or use of the amounts for the expenditures.
- In case where the operating staff is not in a position to do it, because of complexities involved, considerable time is spent in undertaking this type of investigation and often the task is completed in a routine manner.

A structured scrutiny/examination of events or transactions would lead to quick conclusion whether a fraud has occurred and the bank's funds have been siphoned off. Therefore, this exercise is the first critical step towards corrective action in the sense that it would lead to expeditious filing of police complaints, blocking/freezing of accounts and salvaging funds from the blocked/frozen accounts in due course. Besides, once a set of transactions is explicitly identified as fraudulent, the mandate for seizing and taking possession of related documents, issuance of suspension order/order to proceed on leave to identified/suspected employees would be easier thereby preventing them from destroying/manipulating evidences or obstruction of investigations. In this connection, attention is invited to our circular DBS.CO. FrMC.BC.No. 7/23.04.001/2009-10 dated September 16, 2009 wherein it has been advised that they should provide singular focus on the 'Fraud Prevention and Management Function' to enable among others, effective investigation in fraud cases and prompt as well as accurate reporting of fraud cases to appropriate regulatory and law enforcement agencies.

Preventive and Punitive Action: As per the diagnostic analysis, preventive action as deemed necessary to address the 'system failure' and/or punitive action as prescribed internally for 'human failure' should be initiated immediately and completed expeditiously.

Generally, in the current system driven environment in banks, wherever transactions occur in breach of/overriding '*Controls*', they get reflected in the 'end of day exception report'. Accordingly, all such *exception reports* should be perused by the designated officials and a post facto authorisation for the transactions accorded. However, it has been observed in certain cases that the process often does not get duly implemented reflecting the poor internal control mechanisms. Therefore, banks should ensure that they bring in the needed refinement in this process and also specify the levels/authority to whom the exception reports will be invariably submitted and the manner in which the authority will deal with the exception reports. The entire gamut of the manner in which the exception reports are generated, transactions contained in the reports are examined/scrutinised, and the reports submitted to higher authorities for necessary authorizations for breaches should be periodically subjected to review and oversight by the bank's management/Board of Directors.

5. In addition to the above, banks should immediately take steps to put in place following controls and disincentives in their HR processes and internal inspection/audit processes as part of their fraud risk management framework:

a. For key and sensitive posts such as those in dealing rooms, treasury, relationship managers for high value customers, heads of specialized branches, *etc.* the banks should select only such officers who satisfy the 'Fit and Proper' criteria. For the purpose, the banks should draw up a list of critical as well as sensitive positions or areas of operation and evolve well defined 'Fit and Proper' criteria for applying them to determine the suitability of the staff/officers to those posts/areas of operations. The appropriateness of such postings should be subjected to periodical review.

b. The banks should immediately put in place 'staff rotation' policy and policy for 'mandatory leave' for staff. The internal auditors as also the concurrent auditors must be specifically required to examine the implementation of these policies and point out instances of breaches irrespective of apparent justifications for non-compliance, if any. The decisions taken/transactions effected by officers and staff not rotated/availing leave as per policy should be subjected to comprehensive examination by the internal auditors/inspectors including concurrent auditors. The findings thereon should be documented in a separate section of the audit/inspection reports.

c. The banks should build up a database of officers/staff identified as those having aptitude for investigation, data analysis, forensic analysis, etc. and expose them to appropriate training in investigations and forensic audit. For investigation of frauds, only such officers/staff should be deployed through the 'fraud investigation unit/outfit'.

____

RBI/2010-11/556 UBD.BPD.(PCB)CIR No. 50/ 13.05.000(B)/2010-11 dated June 2, 2011

Financing of Self Help Groups (SHGs) and Joint Liability Groups (JLGs) by Primary (Urban) Co-operative Banks (UCBs)

The Chief Executive Officers
All Primary (Urban) Co-operative Banks

As announced in the Monetary Policy 2011-12 [para 100 - appended], with a view to further expanding the outreach of UCBs and opening an additional channel for promoting financial inclusion, it has been decided to allow UCBs to lend to Self Help Groups (SHGs) and Joint Liability Groups (JLGs). UCBs may with the approval of their Board frame a policy in this regard based on the guidelines before undertaking such activity.

____

RBI/2010-11/561 DBOD.BP.BC.No.99/21.04.132/2010-11 dated June 10, 2011

Prudential Guidelines on Restructuring of Advances by Banks

The Chairman and Managing Directors/
Chief Executive Officers of
All Scheduled Commercial Banks
(excluding RRBs & LABs)

Please refer to paragraph 3.4.2(v) of our circular DBOD.BP.BC.No.37/21.04.132/2008-09 dated August 27, 2008 on 'Prudential Guidelines on Restructuring of Advances by Banks', wherein banks were advised that if due to lack of expertise/appropriate infrastructure, they find it difficult to ensure computation of diminution in the fair value of advances extended by their small/rural branches, they will have the option of notionally computing the amount of diminution in the fair value and providing therefor at five per cent of the total exposure in respect of all restructured accounts where the total dues are less than rupees one crore till the financial year ending March 2011. It was also advised that the position would be reviewed thereafter.

2. On a review, it has been decided that the above alternative option of computing diminution in the fair value of advances extended by small and rural branches on restructuring will remain applicable for another two years, i.e. till the financial year ending March 31, 2013. The position would be reviewed thereafter.

RBI/2010-11/562 DGBA. CDD. No. H-8545/15.15.001/2010-11 dated June 9, 2011

Non-implementation of Senior Citizens Savings Scheme – 2004(SCSS) by Certain Banks on Deposit by Army Personnel

It has been brought to our notice that some of the agency banks do not implement the instructions given in Government of India's Office Memorandum F. No. 2-8/2004-NS-II dated October 29, 2004 and circulated to agency banks vide our circular RBI/2004-05/259 Ref. CO. DT. No. 15.05.001/H-3999-4021/2004-05 dated October 30, 2004 , particularly in case of retired army personnel and have denied the facility of this Scheme to some of them in contravention of the instructions ibid.

2. We, therefore, reiterate that you may strictly adhere to the instructions issued vide our above circular and ensure extending the benefits of the scheme to retired army personnel also, if otherwise found in order.

3. You may bring the contents of this and the earlier circulars to all your branches dealing with this scheme.

RBI/2010-11/563 DPSS.CO.OSD. No. 2764/06.11.001/2010-2011 dated June 14, 2011

Directions for Submission of System Audit Reports from CISA qualified Auditor

All Scheduled Commercial Banks

Please refer to our circular Ref. No. DPSS.1444/06.11.001/2010-2011 dated December 27, 2010 on the captioned subject.

It is clarified that the contents of the above circular are applicable to only those entities which operate a payment system under the Payment and Settlement Systems Act, 2007. Accordingly, the requirement of system audits is not applicable where a bank/entity is a participant in various payment systems such as RTGS, NEFT, CFMS, ECS, NECS, Card payment systems (Visa, MasterCard, *etc.*), ATM networks (illustratively like NFS, BANCS) *etc.*

RBI/2010-11/578 DGBA. CDD. No. H- 8842/15.02.001/2010-11 dated June 17, 2011

Public Provident Fund (PPF) Scheme – 1968 – Clarification Payment of Interest in Respect of PPF HUF Accounts

Please refer to our Circular RBI/2010-11/344 DGBA.CDD.No.H-4311/15.02.001/2010-11 dated December 27, 2010, forwarding therewith a copy of Government of India Notification G.S.R.956 (E) dated December 7, 2010, on the above subject.

2. In this regard, Government of India has, vide their letter F.No.7/4/2008-NS.II dated June 1, 2011, decided that interest at PPF rates would be paid on those PPF (HUF) accounts, which had attained the maturity after May 13, 2005 but closed by the subscribers before December 7, 2010, subject to the conditions that the accounts had not been extended thereafter and the deposits were retained in such accounts without further subscriptions.

3. You may bring the contents of this circular to all your branches dealing with this scheme.

RBI/2010-11/582 RPCD. GSSD. CO. No.14360/09.01.01 CM/2010 - 11 dated June 14, 2011

Credit Mobilisation Targets under the Swarnajayanti Gram Swarozgar Yojana (SGSY) for the year 2011-12

The Chairman/Managing Director
All Indian Scheduled Commercial Banks
(Excluding RRBs)

The Government of India has finalised the Credit Mobilisation Targets for the year 2011-12 under the Swarnajayanti Gram Swarozgar Yojana (SGSY). The

State/Union Territory - wise credit mobilisation targets for the year 2011-12 are enclosed.

2. We advise that the State-wise targets indicated may be allocated among the banks working under the jurisdiction of the SLBC Convenor bank of the State, under advice to us. The SLBCs should finalise the targets of individual banks on the basis of acceptable parameters like resources, number of rural/semi-urban branches, *etc.*, so that each of the banks will be in a position to arrive at its corporate target. We will be monitoring the achievement of the credit targets by the scheduled commercial banks through receipt of returns.

3. The Lead Banks may review the performance of credit mobilisation at regular intervals in each State/ Union Territory through the respective SLBC/UTLBC in order to ensure that efforts are being made by the banks to achieve the credit targets.

4. Monthly/quarterly/half - yearly reports may be submitted to us in terms of para 22 of our Master Circular RBI/2010-11/56 - RPCD. SP. BC. No.7/09.01.01/ 2010-11 dated July 1, 2010 on Priority Sector Lending – Special Programmes – Swarnajayanti Gram Swarozgar Yojana (SGSY).

5. Further, as you are aware, we have introduced an upgraded system (PCRPCD) of on-line submission of data by banks in respect of SGSY. The state-wise targets allocated to scheduled commercial banks for the year 2011-12 will be updated in our system, at Central Office, on receipt of the same from your bank. Subsequently, you have to update the state - wise/bank - wise financial targets for the year 2011-12 in your system. This will enable the member banks to submit the returns on-line to us.

6. You may please ensure to submit the progress reports in hardcopy and on-line under PCRPCD simultaneously and continue to do so until further instructions from us.

7. Please issue suitable instructions to your controlling offices and branches, under advice to us.

____

RBI/2010-11/589 DBS. CO.FrMC.BC.No. 11/23.04.001/ 2010-11 dated June 30, 2011

Efficacy of Concurrent Audit

The Chairmen & Chief Executive Officers of
All Scheduled Commercial Banks (excluding RRBs) and
All India Select Financial Institutions

1. A study of large value frauds, including frauds under housing loan segment, reported by banks to Reserve Bank of India was undertaken to understand the gaps in the control mechanism which contributed to perpetration of those frauds particularly when the branches were also under concurrent audit. It was observed that large number of frauds were perpetrated on account of submission of forged documents by the borrowers which had been certified by professionals' ie valuers/advocates/chartered accountants.

2. The reason for failure on the part of concurrent auditors may be attributed to the new/innovative/ complex nature of financial products or transactions. Further, banks have assigned audit responsibility to their own staff without ensuring that they are suitably trained to undertake the audit responsibility.

3. In order to contain the frauds, the banks may put in place a system wherein the concurrent audit would look into the following and report on the following aspects:

i. Wherever documents of title are submitted as security for loans, there should be a system where documents of title are subject to verification regarding their genuineness, especially for large value loans. In case of loan against the security of land, the banks may also seek reports from the local revenue authorities regarding the title deeds before sanction of loan.

ii. Wherever a Chartered Accountant certificate, property valuation certificate, legal certificate, guarantee/line of credit or any other third party certification is submitted by the borrower, the bank should independently verify the authenticity of such certification by directly communicating with the concerned authority issuing the certificate; indirect confirmation may also be resorted to, *i.e.*, indicating to the issuer that in case there is no response by a certain deadline, it would be assumed that the certificate is genuine.

iii. Aspects such as internal discipline, staff rotation, checks and balances, *etc.* should be ensured by the bank.

iv. In cases where it is established that the certification given by a chartered accountant, lawyer, registered property valuer or such third party is wrong, IBA should put in place a process to issue a 'Caution List' regarding the certifier to all banks. In this connection, banks may ensure compliance to our circular DBS.CO.FrMC.BC.3/23.04.001/2008-09 dated March 16, 2009 in the matter.